REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

ESTABLISHING ELECTRONIC FUNDS TRANSFER FOR PAYROLL AND RETIREMENT PAYMENTS: FEASIBILITY, COST, AND SAVINGS

P-268

APRIL 1983

REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

P-268

ESTABLISHING ELECTRONIC FUNDS TRANSFER FOR PAYROLL AND RETIREMENT PAYMENTS: FEASIBILITY, COST, AND SAVINGS

<u>APRIL 1983</u>

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April 26, 1983 P-268

Honorable Art Agnos
Chairman, and Members of the
Joint Legislative Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning electronic funds transfer (EFT) as it relates to a method for distributing payroll and retirement payments using computers and magnetic tapes instead of warrants. It concludes that the State could establish such a system within the existing payment systems. However, we estimate that the financial costs of EFT will exceed the savings. Furthermore, we identify other factors to consider when evaluating EFT.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

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SUMMARY

This report responds to Chapter 1317 and Chapter 1270, Statutes of 1982, which require the Auditor General to determine the feasibility of, cost of, and savings from electronic funds transfer (EFT) as it relates to a voluntary program for the direct electronic deposit of employee payroll and retirement payments into financial institutions. EFT could be established within the existing payment systems and would transfer funds electronically to financial institutions by using computers, magnetic tapes, and automated clearing houses.

Feasibility of EFT

The State could incorporate EFT into the existing payroll and retirement payment systems. Seventeen other states use EFT to transmit payroll or retirement payments directly to financial institutions. The Social Security Administration and the U.S. Department of the Army also use EFT to make payments to beneficiaries.

The State Controller has indicated that EFT is feasible for California but that the State Controller does not want to implement such a system at the present time, primarily because the State may forgo interest income. Furthermore, the State Controller contends that the design and implementation costs for EFT would be greater today than in the future, provided the State Controller is granted approval to replace the existing payroll system. The State Controller plans to replace its payroll system over the next two to three years to make it more cost effective and responsive to changing conditions.

Fiscal Effects of EFT

We estimate that the State would spend $486,000 to develop and implement an EFT system into the existing payment systems. Of this amount, the State Controller would spend $275,000 to redesign its computerized payroll operations and to implement new procedures. In addition, the Public Employees' Retirement System, the State Teachers' Retirement System, and other state agencies would spend $211,000 to develop and implement EFT. These nonrecurring costs would be primarily for modifying computer programs and enrolling employees and retirees who would volunteer to participate in the program.

We further estimate that the State would spend $90,000 each year to operate EFT within the existing payment systems. Most of these expenditures would be for processing fees charged by financial institutions. However, we estimate that by using EFT, the State would save $51,000 each year, thus lowering the annual operating cost to approximately $39,000. The State would achieve these savings by processing and redeeming fewer warrants.

Finally, the State would forgo interest income each year because EFT would require the State to release funds more quickly than the current warrant payment systems. Based upon our assumptions, which include initial participation levels and an effective yield of 12 percent earned by the Pooled Money Investment Account during fiscal year 1981-82, we estimate that the State would forgo $1.4 million in annual interest income by establishing EFT.

Other Factors to Consider

The State currently offers direct deposit options to employees and retirees. State employees can request that the State Controller deduct portions of their pay for deposit in financial institutions. In addition, approximately 83,000 retirees have their warrants mailed directly to financial institutions. On the other hand, EFT would provide greater safety and convenience to employees and retirees and it would benefit state agencies by reducing their need to handle warrants. However, because EFT does not use warrants, it could have an adverse effect on the State's existing internal controls for payroll and result in an increase in the volume of overpayments made to employees. The State could use EFT in systems other than the payroll and retirement disbursement system. For instance, other states use EFT as a cash management tool for disbursing funds and collecting revenues. Financial institutions may benefit if the State implements EFT because they would receive payroll and retirement monies more quickly. Furthermore, because the fees that the State pays to financial institutions for processing payroll and retirement payments could be greater under EFT than under the present system, implementing EFT could increase the income of financial institutions. Finally, EFT may reduce the operating costs of financial institutions.

INTRODUCTION

The processing of the State's payroll and retirement payments involves many state agencies and organizations, including the State Controller and the State Treasurer. The State Controller prepares warrants, controls disbursements, and reconciles payments. The State Treasurer redeems warrants, maintains custody of all money and securities belonging to or held in trust by the State, and invests idle funds to earn interest income. Other organizations involved in the payroll and retirement payment systems are the personnel and payroll offices of state agencies, the Public Employees' Retirement System (PERS), and the State Teachers' Retirement System (STRS).

For fiscal year 1983-84, the Governor's Budget requested approximately $50 million to support the State Controller and $5.1 million to support the State Treasurer. Approximately $20.4 million of the State Controller's funding is for administering the Uniform State Payroll System and issuing and controlling payroll, retirement, and all other warrants. During fiscal year 1981-82, payroll and retirement warrants comprised only 30 percent of the 22 million warrants issued by the State Controller. Furthermore, these warrants

comprised only 13 percent of the 51.9 million warrants, checks, and vouchers processed by the State Treasurer.

Current Payment Systems

Under the Uniform State Payroll System, state agencies submit various documents, including attendance records, to the State Controller. Using these documents, the State Controller calculates salaries and wages and generates a magnetic tape of the payroll information. While processing payroll information, the Personnel/Payroll Services Division can transfer deductions from employees' salaries or wages for direct deposit into other organizations, including financial institutions where the employees have accounts. These transfers, made through a voluntary miscellaneous deduction program, are delivered to the institutions. The State Controller's Division of Disbursements/Administration then drafts the pay warrants and supporting documentation and delivers the payroll to the state agencies approximately two business days before payday so that the agencies' payroll offices can validate the payroll before distributing the warrants to the employees. Payday for most employees is generally in advance of the issue date, which is the date printed on the warrant. Most state employees receive their pay

warrants on the last business day of their pay period. However, the State Treasurer will not redeem warrants before the issue date.

For retirement payments, the PERS and the STRS generate magnetic tapes containing retirement payment information and deliver the tapes to the State Controller. Once the State Controller prints and issues the warrants, it draws amounts from the retirement funds that are equal to the amount of the warrants and places that amount in the General Fund. The State Controller then mails the retirement warrants directly to the beneficiaries or their designated representatives. We estimate that during December 1982, approximately 25 percent of the PERS recipients and 50 percent of the STRS recipients had their warrants mailed directly to financial institutions.

After receiving the warrants from the State Controller, from employees, and from retirement beneficiaries, financial institutions receive funds for the warrants by presenting them to the State Treasurer. The State Treasurer redeems the warrants by transferring to the financial institution state funds equal to the warrant amounts. The time interval (i.e., "float") between the warrant issue date and the warrant redemption date can vary. Between 60 and 80 percent of the payroll and retirement warrant amounts are paid within five

days after the warrants are issued; however, the State Treasurer may redeem warrants up to four years after issuance.

Because the State Treasurer does not release state funds until the warrants are returned, funds remain invested between warrant issue date and warrant redemption date, and the State earns interest income by investing these funds through the Pooled Money Investment Account. This income earned during float is retained by the General Fund. Furthermore, it is an important fiscal factor to consider when comparing the existing systems for processing payroll and retirement payments with the electronic funds transfer.

Electronic Funds Transfer

In contrast to the existing payment systems that produce and distribute warrants, an electronic funds transfer (EFT) does not use documents to transfer funds. Under an EFT system, the State Controller would produce magnetic computer tapes of payment information that is based on data supplied by state agencies and the PERS and the STRS. The State Controller would then provide these tapes to a single financial institution two to three days before the payment date.

The financial institution, using computers, would extract payment information regarding the accounts of its

customers and electronically transmit the remaining information through an automated clearing house to other financial institutions. On the issue date, the State Treasurer would provide the financial institution the funds necessary to meet payroll and retirement obligations. All financial institutions would then make deposits to their customers' accounts.

SCOPE AND METHODOLOGY

We limited our analysis to determining the feasibility of, cost of, and savings from incorporating EFT into the existing payroll and retirement payment systems. Consequently, we make no recommendations about whether or not to implement EFT.

In performing this analysis, we interviewed officials from the State Controller, the State Treasurer, the State Teachers' Retirement System, the Public Employees' Retirement System, and payroll and personnel offices of two large state departments: the Department of Motor Vehicles and the Department of Water Resources. We also interviewed officials in four large financial institutions: Bank of America, The Golden 1 Credit Union, Security Pacific National Bank, and Wells Fargo Bank, N.A. In addition, we contacted administrators who have experience using EFT at the Calwestern

Automated Clearing House Association, in three federal agencies, and in three other states.

During the analysis, we reviewed the State's current payroll and retirement payment systems, examined the capabilities of EFT, and assessed the feasibility, costs, and savings associated with incorporating EFT into the State's current warrant payment systems. We examined the State Controller's preliminary cost studies of EFT, and, with assistance from the agencies administering California's payroll and retirement systems, we determined how the existing systems would change if EFT were incorporated. Accordingly, we estimated the fiscal effects of these changes. Finally, we discussed with officials in the State Controller's Personnel/ Payroll Services Division the potential changes currently being considered for the payroll system.

Based upon certain fundamental assumptions, we calculated the cost and savings attributable to establishing and operating an EFT system. Some of our assumptions reflect the experiences of organizations that use EFT; we formed other assumptions after meeting with the staff involved with the State's existing payment systems. Different assumptions would produce different projections of cost and savings. The following are the key assumptions that underlie our conclusions:

1. The State Controller would plan, design, implement, and test major portions of the EFT system. In addition, the PERS and the STRS would have to adjust their payment systems.

2. The State would use EFT to disburse both payroll and retirement payments and not for any other cash management purposes.

3. The State Controller would provide all payment data to the financial institution that initiates EFT payments two to three days before the payment dates. Therefore, the financial institution could transmit the data through the automated clearing house to all other financial institutions before the payment date.

4. The State Treasurer would release funds on the issue date to the financial institution involved in the EFT. The financial institutions we contacted indicated that this would be an acceptable practice.

5. EFT would be a voluntary program with approximately 30 percent of the state employees participating initially. This compares to participation rates for employees in other state and federal organizations. Further, based on the current participation rates in the direct mailing of retirement payments, we estimate that 50 percent of the State Teachers'

Retirement System beneficiaries and 25 percent of the Public Employees' Retirement System beneficiaries would initially use EFT.

6. State employees who participate in EFT would be given their earnings statements by their agency's payroll office as under the existing system. Furthermore, the State Controller would mail monthly earnings statements to all retirement beneficiaries who participate in EFT. According to the Manager of the Fiscal Systems of the State Controller, monthly statements for EFT payments would be easier to administer than quarterly statements required by state law. He stated that it would be more practical to audit and control payments on a monthly basis rather than quarterly.

7. The earnings rate for funds invested in the Pooled Money Investment Account would be 12 percent, equal to the effective yield for fiscal year 1981-82. Further, we assumed that the State would have sufficient funds invested in this account to meet payroll and retirement payments.

8. The bank service fees for processing EFT payments would be $30 per magnetic tape plus 4 cents per transaction, the current commercial rate charged by a

major financial institution. These fees would be paid by the State Treasurer.

Using these assumptions, we determined the minimal changes that would be made to the existing payment system, and we calculated the fiscal effects based upon these changes. We asked the State Controller, the State Treasurer, the PERS, and the STRS to estimate the operational changes and related savings and costs that would result from establishing EFT. We then evaluated their estimates for reasonableness and accuracy, and we resolved any concerns that we had about their projections.

ANALYSIS

ESTABLISHING ELECTRONIC FUNDS TRANSFER FOR PAYROLL AND RETIREMENT PAYMENTS: FEASIBILITY, COST, AND SAVINGS

Chapter 1317 and Chapter 1270, Statutes of 1982, require the Auditor General to examine the feasibility, cost, and savings of establishing direct deposit by electronic funds transfer (EFT) of the State's payroll and retirement payments. We found that the State can incorporate EFT into the existing payment systems, and we estimate that such a system would cost the State $486,000 to develop and implement. The annual cost to operate EFT would be an additional $90,000. However, because EFT does not require the processing of payroll and retirement warrants for persons who use EFT, the annual operating cost would be reduced by an estimated $51,000. Furthermore, the State would forgo earning an estimated $1.4 million annually in interest income because by using EFT the State would be releasing its funds sooner to financial institutions. This estimate is based upon certain assumptions and upon estimates of the number of state employees and retirees participating initially.

In the following sections, we provide information on the feasibility of incorporating EFT into the existing payment

systems, information on the estimated cost and savings associated with establishing EFT, and other information pertinent to evaluating an EFT direct deposit program.

Feasibility of EFT

We consider a system "feasible" if it is possible to implement. According to this definition, we have concluded that it is feasible for the State to implement EFT for payroll and retirement payments. EFT systems have been available for some time, and such systems are being used by federal agencies, private organizations, and 17 states. For example, the Social Security Administration and the U.S. Department of the Army use EFT to make payments to beneficiaries. North Carolina uses EFT to distribute its payroll, and the State of Washington uses EFT to deposit both payroll and retirement payments.

The State Controller's staff has made preliminary studies of the effects of EFT on the existing payroll and retirement systems and on the interest income that the State earns. Based on those studies, the Deputy State Controller for Legislation concluded that the State should not implement EFT because of the cost to implement the system and because the State would lose interest income. Further, the State Controller is planning a new system that is to reduce State expenditures and should be able to provide direct deposit by

EFT. Referred to as California Personnel/Payroll System (CAPPS), this project, if approved, will replace the computer systems that perform the State's personnel, payroll, and attendance accounting functions.

Currently, the Personnel/Payroll Services Division is developing the requirements of the CAPPS for the Request for Proposal. If the State Controller can obtain the necessary funding and authorizations, the State Controller plans to implement the new system within two to three years.

Fiscal Effects of Implementing EFT

Assisted by the agencies involved with the existing payment systems, we estimated the fiscal effects of EFT. We calculated the additional costs and savings that the State would incur if EFT were established within the existing payment systems. Our estimates did not include the fiscal effects pertaining to individuals who do not elect to participate in EFT. The cost of developing and implementing EFT is a one-time cost. Operating cost, savings, and interest income would be affected each year that EFT operates.

The State would spend $486,000 to develop and incorporate EFT into the existing systems for payroll and retirement payments; it would spend approximately $90,000

annually to operate the system. However, the system would generate nearly $51,000 in operating savings; thus, the net annual operating cost would be $39,000. Finally, under EFT, the State would forgo earning annual interest income because payroll and retirement funds would be withdrawn sooner from the Pooled Money Investment Account. Based on our assumptions and an effective yield of 12 percent earned by the Pooled Money Investment Account during fiscal year 1981-82, we estimate that the State would forgo $1.4 million in interest income if it implemented EFT.

Estimated Cost To Develop and Implement EFT

We project that the State would spend $486,000 to develop and implement EFT as an additional method of disbursing funds under the existing payment systems. These costs would be incurred by the State Controller, the Public Employees' Retirement System (PERS), the State Teachers' Retirement System (STRS), and other state agencies. As shown in Table 1 below, the State Controller would incur more than half of the cost of developing and implementing EFT.

TABLE 1

ESTIMATED COST TO DEVELOP AND IMPLEMENT
AN ELECTRONIC FUNDS TRANSFER SYSTEM
(Rounded to the nearest thousand)

Organization	Development and Implementation Cost
State Controller	
Systems Development Division	$114,000
Personnel/Payroll Services Division	109,000
Division of Disbursements/ Administration	52,000
Subtotal	$275,000
Public Employees' Retirement System	93,000
State Teachers' Retirement System	48,000
State Agencies' Personnel and Payroll Offices	70,000
Total	$486,000

The State Controller would incur $275,000 of the costs for developing and implementing EFT. Its Systems Development Division would incur the largest portion of the costs because this division would plan, design, and test major portions of the computer systems. This division would have to redesign the existing computer payment files to accommodate bank identification numbers. In addition, the Personnel/Payroll Services Division would spend approximately $109,000 to develop the new payroll procedures and to process employee EFT authorization documents. Finally, the Division of

Disbursements/Administration would incur costs of $52,000 for training State Controller personnel in the new payroll procedures and for transferring information from the employee authorization forms to the computer files.

The PERS and the STRS would incur developmental and implementation costs of $93,000 and $48,000, respectively. Both of these organizations would have to reprogram their computers and process authorization forms. For instance, the PERS estimates that it would cost approximately $32,000 to notify its retirees by mail that they may use EFT.

We estimate that personnel and payroll offices at state agencies would incur $70,000 in expenses to implement EFT. These costs, the only implementation costs that we were able to estimate for state agencies, would be for processing employee authorization forms.

The State Treasurer may not incur any development and implemention costs for EFT. According to the Chief of the Data Processing Division, EFT would probably not create any major changes in the State Treasurer's existing procedures.

Our cost estimates for developing and implementing EFT are conservative because neither we nor the agencies we contacted could determine all the changes that EFT may produce.

According to officials of the State Controller, EFT may require additional security procedures to protect EFT payment data when they are being conveyed to the financial institution that initiates payments. Moreover, the payment files for EFT recipients must contain additional confidential information such as individual account numbers.

Estimated Annual Cost and Savings Attributable to EFT

We estimate that EFT would cost the State an additional $90,000 each year to operate. However, a portion of these operating costs would be offset by $51,000 in operating savings. As shown in Table 2 below, we estimate that two divisions of the State Controller would incur approximately $12,000 of the total operating costs. The operating costs incurred by the State Controller relate to processing and amending employee authorization forms.

TABLE 2

ESTIMATED COST AND SAVINGS ATTRIBUTABLE TO OPERATING ELECTRONIC FUNDS TRANSFER
(Rounded to the nearest thousand)

Organization	Annual Cost	Annual Savings
State Controller		
Personnel/Payroll Services Division	$ 9,000	--[a]
Division of Disbursements/ Administration	3,000	13,000
Subtotal	$12,000	$13,000
Public Employees' Retirement System	2,000	8,000
State Teachers' Retirement System	2,000	6,000
State Treasurer	74,000	24,000
Total	$90,000	$51,000

[a] State officials did not estimate any fiscal effects.

The State Controller's Personnel/Payroll Services Division did not estimate any significant operating savings because its existing functions would continue whether or not the State implements EFT: it would continue to administer the payroll system and process personnel and payroll documents from other state agencies. On the other hand, the Division of Disbursements/Administration would save $13,000 because it would print and make microfilm of fewer warrants. However,

because this division would continue producing and distributing monthly earnings statements, which are easier to administer than quarterly statements, EFT would not reduce the division's postage costs and would not materially reduce the cost of documents.

We estimate that the PERS and the STRS would each spend $2,000 in additional operating costs to produce the payment files for EFT. However, each year the PERS and the STRS would annually save approximately $8,000 and $6,000, respectively, because EFT would result in fewer lost warrants, thus reducing administrative costs.

We estimate that the State Treasurer would incur $74,000 in operating costs because of processing charges from financial institutions. This estimate is based upon the present commercial rate for EFT payments charged by one major financial institution. However, because the State Treasurer would redeem fewer warrants, the State would save approximately $16,000 in processing charges for warrants and $8,000 in state administrative costs.

We did not estimate the operating costs and savings applicable to other state agencies because we could not determine how much EFT would affect their operations. However,

as we discuss later in this report, we did determine that EFT would affect the method by which state agencies control overpayments.

Estimated Interest Loss Due to Implementing EFT

Each year the State would forgo earning interest income if it implements EFT. Using the assumptions discussed below, we estimate that the State would forgo $1.4 million in interest income. However, different assumptions would produce different effects on interest income. We based our calculations on warrant redemption patterns of employees and retirees during the first nine months of fiscal year 1980-81. Our calculation assumes an effective yield of 12 percent, equal to the rate earned in the Pooled Money Investment Account during fiscal year 1981-82. In addition, we estimate that 30 percent of the state employees, 25 percent of the PERS retirees, and 50 percent of the STRS retirees would participate initially in an EFT direct deposit program.

As mentioned previously, the current warrant payment systems allow the State to continue to invest the funds needed to redeem the warrants during the period (float) between the date the State Controller issues the warrants and the date the State Treasurer redeems the warrants and releases the state funds. In contrast, an EFT system requires the State Treasurer

to release state funds on the same date that warrants are issued under the current warrant system. Consequently, the State would not have float and would not have the opportunity to continue to earn interest income on the funds needed to meet payroll and retirement payments.

Other Factors to Consider When Evaluating EFT

The fiscal effects on the payroll and retirement payment systems are not the only factors to consider when evaluating EFT. Other factors could directly influence the existing payment systems, state employees and retirees, and financial institutions. EFT could replace the methods that the State already offers employees and retirees for direct deposit of their payments. Furthermore, EFT could provide other benefits to the State, its employees and retirees, but incorporating EFT into the existing payroll system would also increase the potential for overpayments to employees. Besides using EFT in its disbursement system, the State could use EFT in other systems to collect revenues or for other cash management purposes. Finally, EFT payments could increase the income of the financial institutions while also reducing their operating costs.

Existing Direct
<u>Deposit Methods</u>

EFT could change the State's current direct deposit methods. Although California does not offer direct deposit by EFT, the State Controller can deduct funds from an employee's pay and deposit those funds directly into financial institutions or make payments to other organizations. According to one of the State Controller's analysts responsible for portions of the deduction program, approximately 88,000 state employees deposited a total monthly average of $17.8 million into their credit union accounts between June 1982 and October 1982.* The State Controller recovers the costs of this deduction program by charging the companies and financial institutions receiving the deducted funds. We estimate that during November 1982, approximately 3,500 employees received more through direct deposit to credit unions than they received in their pay warrants.

The State originally intended the deduction program to withhold and transfer payments for loans, savings, union dues, life insurance, and car insurance. Employees can also use this program for a direct deposit of their payroll.

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* Effective January 1, 1983, Section 1151 of the Government Code allows state employees to make similar arrangements with banks, savings and loans, and industrial loan institutions.

The State also directly mails retirement warrants to financial institutions. We estimate that approximately 25 percent of the 176,000 PERS beneficiaries and approximately 50 percent of the 93,000 STRS beneficiaries had their warrants, worth over $41 million, mailed directly to financial institutions during December 1982.

Other Benefits to the State and to EFT Participants

Automatic payroll deposit by EFT would benefit state agencies by improving their payroll services. For example, EFT would reduce certain activities associated with disbursing warrants. These activities include securing and storing warrants and making special arrangements for employees who are absent due to travel, vacation, or illness. Also, since EFT eliminates warrants, agencies would not have to issue stop payment and reissue orders for lost or stolen warrants, and their employees would not leave work to deposit paychecks.

Similarly, because EFT direct deposit eliminates the possibility of lost or stolen warrants, EFT offers safety and convenience to employees and retirement recipients. Also, with direct deposit, employees and retirees may not have to travel to financial institutions to make deposits, and employees may not have to make special arrangements for handling warrants when the employees are absent.

Potential for Overpayments

In addition to its advantages to the State, EFT may have an adverse effect on the State's existing system of internal controls, resulting in additional overpayments for payroll. If the State incorporates EFT into the existing attendance reporting and payment systems, more employees would be overpaid than are overpaid under the current systems.

Section 8580.2 of the State Administrative Manual requires state agencies to verify payroll warrant amounts by checking attendance reports before distributing the warrants to the employees. When the amount on a warrant represents an overpayment, Section 8580.3 of the State Administrative Manual requires an agency to withhold the warrant and return it to the State Controller. During 1982, agencies returned approximately 57,000 payroll warrants to the State Controller.

However, state agencies would not be able to exercise this control for EFT participants. According to bank representatives we contacted, financial institutions must have the payment information two to three days before the payment date so that the funds can be posted to the customers' accounts in time to comply with state payroll procedures that require state employees to be paid on payday. Moreover, Section IIB of the National Automated Clearing House Association's operating

guidelines does not allow the employer to stop an EFT payment or reverse an entry once the payment data reach the automated clearing house. Consequently, if EFT were incorporated into the existing payroll system, state agencies could not prevent overpayments by exercising current internal control procedures of withholding payments.

Alternative Uses For EFT

California could use electronic funds transfer in systems other than the payroll and retirement disbursement system. We found that other state governments, such as Washington, Massachusetts, and North Carolina, use EFT as a cash management tool not only to disburse funds but also to collect revenues. The Assistant State Treasurer of the State of Washington said that the State Treasury works closely with the counties to use EFT to collect such revenues as property taxes and sales taxes. The Assistant State Treasurer of the State of Washington said that because EFT is used to collect funds, Washington has reduced the interest income forgone because funds are disbursed through EFT. In another example, the State of Pennsylvania currently offers a voluntary EFT program for payroll and retirement payments. Within five years, Pennsylvania plans to implement EFT for handling all receipts and disbursements.

Benefit to
Financial Institutions

If the State uses EFT to deposit payroll and retirement payments, financial institutions would gain certain benefits. First, financial institutions would benefit by obtaining custody of the funds sooner. EFT would provide funds to financial institutions on the date that the warrants could be redeemed by the State Treasurer. As a result, if the financial institutions have an effective yield on investments of 12 percent, the same as we projected that the State would earn on its funds, and if the institutions comply with the deposit requirements of the Federal Reserve System, they would earn approximately $1.2 million from having custody of state funds at an earlier date.

Furthermore, EFT may enable financial institutions to earn more from the service fees they charge. These fees are negotiable, and contract negotiations between the State and the financial institutions could influence the amount that financial institutions receive for the services. For example, the State Treasurer pays financial institutions approximately one cent for each warrant the State redeems. In contrast, a major financial institution charges a commercial fee of four cents per EFT transaction and $30 for processing each computer tape. If the State were to pay financial institutions this same rate for EFT processing, the financial institutions

would earn more from EFT than they would earn by processing warrants. Based on our assumption about the EFT participation rates, we estimate that the total annual fees the State would pay to financial institutions is approximately $74,000 for EFT service compared to $16,000 in bank charges for processing warrants.

Finally, financial institutions may reduce their administrative costs if the State implements EFT. For example, according to officials of a financial institution currently receiving electronic funds transfers, financial institutions can make deposits to customers' accounts without creating a deposit slip or without having a teller wait on these customers. Furthermore, under the EFT system, financial institutions would have shorter customer lines on payday, have fewer transaction errors to correct, and face less potential for check fraud.

CONCLUSION

It is feasible for the State to develop an electronic funds transfer (EFT) system and incorporate it into the existing payment systems to provide direct deposit of payroll and retirement payments. Seventeen other states use EFT for direct deposit transactions. However, the State Controller does not

plan to implement EFT at the present time because the State would forgo interest income. Furthermore, the State Controller proposes to change the entire payroll system within the next three years; the revised system should be capable of providing direct deposit of funds by EFT.

We estimate that the State would spend $486,000 developing and incorporating an EFT system into the existing warrant systems. In addition, the State would spend an estimated $90,000 annually to operate the additional system. Annual savings of $51,000 would partially offset these operating costs. We further estimate that based upon our assumptions, the State would forgo $1.4 million in annual interest income if it were to implement an EFT direct deposit program.

Finally, there are other factors besides fiscal effects to consider when evaluating an electronic funds transfer system to disburse payroll and retirement funds.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specifically contained in the audit request.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

Date: April 25, 1983

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April 22, 1983

Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Hayes:

We have reviewed your draft report entitled "Feasibility, Cost, and Savings of Establishing Electronic Funds Transfer for Payroll and Retirement Payment".

We are particularly concerned about the problem identified in the report regarding the potential for additional overpayments resulting from incorporating EFT into existing attendance reporting and payment systems. We believe the problem could be very significant over an extended period as EFT in effect eliminates the current internal control procedures of verifying payroll warrant amounts against attendance reports <u>before</u> warrant distribution.

We would also like to direct our remarks to the various sections of the report relevant to the cost of implementing the new system. Precisely because of such cost factors, we continue to believe it is inappropriate to implement a direct deposit fund transfer program at this time.

Thank you for the opportunity to comment on the report.

Sincerely,

Kenneth Cory

KC:jcg

State of California | State and Consumer Services Agency

Memorandum

To: Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, CA

Date: April 22, 1983

From: Office of the Secretary
(916) 323-9493
ATSS 473-9493

Subject: Comments of Electronic Funds Transfer Study - Chapter 1317 and Chapter 1270, Statutes of 1982

During 1982, legislation addressing the subject of Electronic Funds Transfer (EFT)required the Auditor General to study the feasibility and associated costs and benefits of providing EFT, for state payroll and retirement benefit payments. State and Consumer Services Agency appreciates the opportunity to include comments as a part of the report, to the legislature.

The availability of EFT has several advantages to payment recipients which are difficult to measure. Further, we believe the value of these advantages differs for the two populations involved; state employees, and state and public agency retirees. Although legislation did not direct the Auditor General to consider the state payroll system separate and apart from the retirement benefit payment system, it certainly did not preclude such an approach. Because both systems were studies as a single system, there was heavy emphasis on the Controller's current payroll processing capabilities, which has little to do with the disbursement of retirement benefit payments. The convenience and safety provided by EFT may have a greater value to retirees who, because of the physical limitations of age and because of travel plans, find it difficult to take warrants to their financial institution.

In the report, there are several costing assumptions made which have a heavy impact on the fiscal effects of EFT. These assumptions include a 12% interest factor to cost the potential loss of float. This is the 1982 interest factor, which may no longer be appropriate. Another assumption is the 4¢ per EFT transaction, which is negotiable. We understand the state currently pays a 1¢ per warrant cost to financial institutions. This is considerably lower than the published rate. We suggest the state,

through negotiation, can reduce the EFT transaction cost, thus significantly reducing the costs of operating EFT.

We conclude that this report places great emphasis on the difficulty and cost of implementing EFT for the state payroll and loss of income to the General Fund, while it minimizes the aspects the Agency considers particularly important; safety and convenience to retirement benefit recipients and reduction of paperwork. We believe that, had the system of retirement payments been considered as a separate report, benefits, both tangible and intangible may have proven EFT to be an appropriate alternative method of payment.

SHIRLEY R. CHILTON
Secretary of the Agency

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps